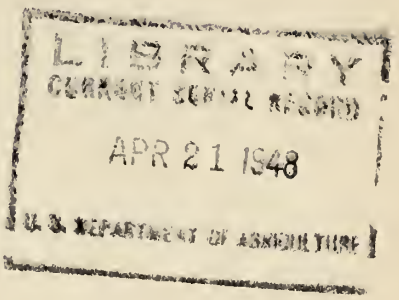
United States Department of Agriculture
FARM CREDIT ADMINISTRATION
Washington, D. C.



SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

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For the

COOPERATIVE RESEARCH AND SERVICE DIVISION

Summary No. 37 March 1948

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Patrons Equity Reserve Held Taxable

In the case of Fountain City Cooperative Creamery Association v. Commissioner of Internal Revenue, 9 T. C. ____, it was held that $5,088.55 in an account known as "Patrons Equity Reserve" was not deductible or excludible in computing the income taxes of this nonexempt cooperative. The opinion of the Court reads as follows:

"Harlan, Judge: This proceeding involves deficiencies in income and declared value excess profits taxes for the calendar year 1943 as follows: Income tax, $1,393.55, and declared value excess profits tax, $142.22; total, $1,535.77.

"Petitioner filed with the collector of internal revenue for the district of Wisconsin its corporation income and declared value excess profits tax return, Form 1120, for the calendar year 1943. This return showed total gross income of $63,383.45, total claimed deductions of $62,794.04, including a deduction for 'Patrons Equity Reserve' of $5,088.55, and normal tax net income of $589.41. The Commissioner disallowed the claimed deductions of $5,088.55 for 'Patrons Equity Reserve.' The petition herein alleges error in respect to such disallowance. Other adjustments made in the deficiency notice are not in dispute. The question before this Court is as to the propriety of this disallowance.

"Petitioner was incorporated in 1900 under the provisions of section 1786-e of the Wisconsin Statutes of 1898, entitled 'An Act to provide for the formation and government of mutual, reciprocal or cooperative associations wishing to engage in the manufacture or distribution of products or the transaction of general business.' The articles of incorporation provided that the business of the taxpayer was to operate a creamery upon the mutual, reciprocal, or cooperative plan. The charter also provided that 'members and not shares of stock shall vote in electing officers and transacting business of whatsoever nature, but no proxies shall be allowed.' Petitioner's charter was amended in 1901 in order to increase its capital stock and again in 1922 to provide additional procedure for members' meetings, but the record discloses no amendment to the charter whereby the taxpayer ever limited the amount of dividends payable to its stockholders or specifically declared itself to be operated under the provisions of chapter 185 of the Wisconsin Statutes of 1941 and/or 1943. The statute under which petitioner was incorporated provided no limitation on the amount of dividends.

"From the time of its incorporation petitioner was engaged in the buying of butter and butter fat and the processing of butter fat and the selling of butter.

"The taxpayer's patrons consisted of producers of butter fat, some of whom were also stockholders in the taxpayer corporation.

"The taxpayer also purchased from other creameries processed butter and resold the same, but such customers were not considered patrons of the taxpayer.

"At no time prior to the taxable year did the taxpayer declare any dividends to its patrons. At the beginning of 1942 it had an accumulated paid in surplus of $24,523. At the beginning of 1943 said surplus amounted to $26,430.53. At the December 14, 1943, meeting of the directors a 5 per cent dividend on all outstanding stock was declared, and it was further resolved:

> 'That all the remaining net income for said fiscal year is hereby distributed among the patrons of this association, both members and nonmembers, in the form of patrons equity reserve, in proportion to the monetary value of the dairy products delivered to the association during said fiscal year.'

"Subsequently, notice was sent to each of petitioner's patrons showing the amount of butter fat sold by each patron during 1943 and the proportionate interest that each patron had in the so-called patrons' equity reserve, which reserve amounted to $5,088.55.

"On February 2, 1944, the action of the board of directors of December 14, 1943, was approved and an amendment to the bylaws was adopted providing for the operation of a patrons' equity reserve, pertinent parts of which provide:

> '* * * Whenever in the opinion of the board of directors the reserves are greater than reasonably necessary for the sound financing of the association, such excess at the discretion of the board of directors may be used to pay off ratably, by years, the equity reserve contributions of patrons, beginning with the oldest. Whenever in a given year the operation of the association results in a net loss, such loss, to the extent that the patrons equity reserve is available, shall be charged against it and the reserve shall be reduced accordingly; and be apportioned among the reserves of the different years in such proportions as the board of directors in their discretion consider equitable. * * * All debts of the association, both secured and unsecured, shall be entitled to priority over all patrons equity reserves.'

"No payment has been made by the taxpayer to any patron out of this equity reserve, nor has any of taxpayer's patrons demanded any payment.

"In his notice of deficiency the Commissioner explained his action in the following words:

> 'The deduction of patrons' equity reserve in the amount of $5,088.55 is disallowed inasmuch as there is no specific

statutory provision for the deduction claimed, and the amount cannot be excluded from income for the patrons' rights to receive the reserve depend upon some corporate action to be taken by the corporate board of directors.'

"It is agreed by both parties that the taxpayer is not a tax-exempt organization within the meaning of section 101 (12) of the Internal Revenue Code or of any other provision of the internal revenue laws.

"The Commissioner further contends that the taxpayer is not a cooperative association within the meaning of the Wisconsin laws governing such associations for the taxable year 1943; that since its organization it has not operated as a true cooperative; and that under any circumstances the so-called patrons' equity reserve is neither deductible nor excludible from petitioner's taxable income for the year 1943.

"Chapter 185 of the Wisconsin statutes of 1941 and 1943 sets forth the Wisconsin law controlling cooperative associations. Section 185.01 of that chapter provides:

'In this chapter, unless the text or subject matter otherwise requires "cooperative basis" as applied to a cooperative means that: (a) Each member has one vote and only one vote; (b) the rate of dividends upon stock is limited to eight per cent; (c) the net proceeds from the business of such corporations are distributed to the patrons in proportion to the volume of business transacted by such patrons with the corporation; provided that deductions may be made as required or authorized by the law of this state.'

"Section 185.19 of said chapter provides that any corporation organized under the general laws may become a cooperative by adopting a resolution at any regular or special meeting of its stockholders and properly filing the resolution as a certificate of amendment to the articles of incorporation.

"Section 185.165 of said chapter provides that upon dissolution the directors 'may apportion and distribute all surpluses, reserves and other assets of the business either paying or providing for the payment of all the known indebtedness of the association and all expenses * * * to the members thereof in accordance with the property rights of the members.'

"The petitioner herein could not qualify under the Wisconsin statutes controlling cooperative associations during the taxable year, for the reason that neither in the law under which it was organized nor in its charter, nor in any amendment thereto has it ever limited the amount of its dividends payable to its stockholders as provided in section 185.01 above; nor has it ever amended its charter specifically bringing itself under the provisions of chapter 185 of the

Wisconsin statutes of 1941 and 1943. From the record therefore it would seem that, regardless of the taxpayer's inclusion in its title of the word 'cooperative' and of its provision that its stockholders shall have but one vote regardless of the amount of stock held, it has never limited the amount of dividends which it may pay to its stockholders and has therefore never made any provision for any enforceable distribution to its patrons.

"The Commissioner further contends that, even if the petitioner were a cooperative association within the provisions of the 1941 and 1943 statutes of Wisconsin, it nevertheless has never operated as such because it has never distributed any profits to its patrons, but has accumulated its profits in the form of a paid-in surplus to the approximate amount of $26,000, which surplus in the event of dissolution of the company would inure to the profit of the stockholders. It is to be noted that such disposition of all surpluses and reserves is recognized by section 185.165 of the Wisconsin statutes above set forth. Because of the accumulation of this reserve and the complete failure to pay any patrons' dividends, our finding is in support of the Commissioner's contention that the taxpayer has not operated as a cooperative.

"However, if our finding were in favor of the taxpayer on the two prior contentions, we would still be unable to find any justification in law for the deduction or exclusion of the patrons' equity reserve as contended for by the taxpayer, which relies very largely on United Cooperatives, Inc., 4 T.C. 93. In that case, however, a patrons' dividend was actually declared and paid, as distinguished from the case at bar, where there is merely a certificate issued to the patron to be honored at some indefinite future time when the board of directors decides that 'the reserves are greater than reasonably necessary for the sound financing of the association,' provided that the debts of the association have not absorbed this reserve by virtue of their prior claims thereon. The effect of the above provision in the certificates and in the bylaws is to declare that this is a reserve if the money is not needed for any other purpose and if, as, and when, the directors subsequently decide that any patrons' dividend might be paid. It is difficult to see much if any distinction between this reserve and the general funds of the taxpayer. Certainly, the patrons would have no method whatsoever of enforcing the payment of any amount on their certificates until the directors had taken a subsequent action. Petitioner in its brief states as follows:

> 'We concede that the practice of excluding the so-called "Patronage Dividends" from gross income, or rather from "Net Proceeds" as defined by the Wisconsin Statutes hereinbefore cited, must be limited to those cases in

which the right of patrons to such dividends arises by reason of the mandatory provisions of the statutes of the State under which the corporation was organized and has operated or by reason of the corporate charter or by-laws or some other contract, express or implied, and does not depend upon some corporate action taken subsequent to its receipt of the money later so distributed, such as the action of the corporation's officers or directors. This limitation recognizes that if the money later distributed is received by the corporation without legal obligation existing at the time of its receipt to later distribute it, it must be considered as the gross income of the corporation, and if there is no deduction permitted by statute of the amounts later distributed to patrons it is taxable as such.'

"It is certainly difficult to discern any legal principle whereby petitioner's directors could be compelled under any statutory law of Wisconsin to declare a patrons' dividend in a corporation in which there is no limit on the stockholders' dividends, even if the petitioner could bring itself within chapter 185 of the 1941 and 1943 statutes of Wisconsin. Section 185.165 thereof vests in the discretion of the directors of recognized cooperatives, powers to do the following acts prior to the declaration of any patrons' dividend:

"(1) They may set aside as a reserve fund such amount as the directors see fit;

"(2) They may pay stockholders' dividends not to exceed 8 percent of the par value of the stock;

"(3) They may set aside an educational fund to teach cooperation in an amount not to exceed 5 percent of the remaining net proceeds;

"(4) They may pay the employees a bonus in an amount depending upon the salary earned and the amount of the patronage distributions;

"(5) They may expend for the 'general welfare' of the association's members any amount deemed necessary. Thereafter they may vote a patronage dividend out of the remainder of their net income, provided the requirements of the directors' and officers' salaries permit.

"The Supreme Court of Wisconsin, in Pearson v. Clam Falls Cooperative Dairy Association, 243 Wis. 369; 10 N.W. (2d) 132, held it was entirely discretionary with the association

whether or not a patrons' dividend should be declared and whether that dividend should be in cash or stock. The court said:

> 'By section 185.16 it was within the discretion of the directors or a majority of the stockholders whether or not patronage dividends would be declared. They could put this cash surplus into some other fund, but they chose to give the patrons a credit payable in Dawn Dairy stock. We think plaintiffs are bound by this decision.'

"Under the above decision, the provisions of the statutes of Wisconsin, and the terms under which this reserve was declared, it is our conclusion that the deduction or exclusion herein claimed by the petitioner is wholly unwarranted and it would seem that the petitioner, by the admissions in its brief, concedes as much.

"Since the Court is uninformed as to whether or not all tax issues have been settled on the other items in the deficiency notice,

Decision will be entered under Rule 50."

Attention is called to the fact that in the notice of deficiency issued by the Commissioner of Internal Revenue, he said that the patrons equity reserve "cannot be excluded from income for the patrons' rights to receive the reserve depend upon some corporate action to be taken by the corporate board of directors." (Underscoring added.) In other words, the Commissioner refused to allow the patrons equity reserve to be deducted or excluded because the association was not under a firm mandatory obligation at the time of the business transactions in question to return such reserves to the patrons from whom they were received on a patronage basis.

In the foregoing opinion considerable stress is placed upon the fact that the cooperative was not restricted in the amount of dividends which it could pay on its outstanding capital stock, and presumably the Tax Court was of the opinion that the entire amount of patrons equity reserve could have been paid out in dividends on the capital stock. Again, the Court seems to have been affected by the fact that under the law of Wisconsin amounts received by a cooperative over and above its operating and maintenance costs and expenses could be used for various purposes before any patronage dividends were paid at all. The comments by the Tax Court regarding the statutory provisions emphasize the fact that the cooperative was not under a firm mandatory obligation to return to its patrons amounts received by the cooperative over and above its operating and maintenance costs and expenses. It would seem that statutory provisions like those referred to in the opinion of the Court would come into play only in instances in which the manner of operation of the association would result in funds with reference to which the statutory provisions would have application. Obviously, if

an association operated on exactly a cost basis, there would be no funds with reference to which some of the statutory provisions quoted in the opinion would have application.

In the opinion considerable stress is placed upon the fact that there were no provisions in the organization papers for returning, apparently in cash, to the patrons the amounts which they had contributed to the patrons equity reserve. It may be that the Court did not intend that the association should be obligated to return the patrons equity reserve in cash, although language in the opinion would seem to suggest that the Court had this in mind. In American Box Shook Association v. Commissioner of Internal Revenue, 156 F. 2d 629, it was said:

> "In order to be a true cooperative, however, the decisions emphasize that there must be a legal obligation on the part of the association, made before the receipt of income, to return to the members on a patronage basis, all funds received in excess of the cost of the goods sold. Such an obligation may arise from the association's articles of incorporation, its by-laws, or some other contract." (Underscoring added.)

Attention is called to the word "return" in the foregoing quotation. At least insofar as the Tax Court of the United States is concerned, however, it would appear that the so-called return need not be made in cash because in United Cooperatives, Inc., v. Commissioner of Internal Revenue, 4 T.C. 93, the return was made in common stock, and the Court held that the amount of the common stock covered by such return was excludible in computing the income taxes of the nonexempt cooperative. In this case it appeared that the bylaws of the association obligated it to make returns in stock or in cash to its patrons - members and nonmembers alike. As a matter of fact, the association made returns in the form of common stock. In this connection it was said:

> "The result of the procedure set up by petitioner's bylaws was as if the stockholder member who was under obligation to purchase additional stock had received, in cash, the 'patronage dividend' and had thereupon applied this sum to the payment of his stock. The stock, when thus paid and issued to him, was not in the nature of a stock dividend, but represented an additional investment on his part to the capital of the corporation out of his savings from the annual transactions with petitioner." (Underscoring added.)

In other words, in the United Cooperatives, Inc., case, the excess amounts over and above operating and maintenance costs and expenses and which the association was required to evidence in stock were treated as capital investments by the patrons. It would seem clear that capital could be evidenced in other ways than by certificates of stock if the organization papers provided therefor. It will be recalled that amounts received as capital are not income and hence are not liable for income taxes. Again, money having the technical status of capital is not indebtedness and therefore no time for its repayment is required.

In the Fountain City Cooperative Creameries Association case, the Tax Court laid some emphasis upon the fact that all or part of the patrons equity reserve might be lost, and that the association therefore might not be in a position to return any of the reserve in cash. Of course, in an instance in which stock is issued as was done in the United Cooperatives, Inc., case, losses could occur which would impair the book value of the stock. Moreover, there does not appear to have been any provision in the organization papers in the United case which in any way obligated the cooperative to make returns at any time in cash. In the United Cooperatives, Inc., case, it will be recalled the Tax Court specifically held that the organization papers of that cooperative constituted a mandatory obligation requiring the cooperative to account to its patrons, and this obligation was found to be entirely independent of any action on the part of the board of directors of the cooperative. Obviously, if action on the part of the board of directors is necessary to determine if a cooperative is to make returns to its patrons, there would be no mandatory obligation.

A Cooperative Director's Responsibilities

By
Judge Willis I. Morrison
Los Angeles

The title assigned, "A Cooperative Director's Responsibilities," that I am to discuss from the legal standpoint suggests, perhaps with some justification, that a line of demarcation is to be drawn between the duties and responsibilities of a cooperative director and those of a director of the ordinary corporation operated for a profit. However, from the legal standpoint, the duties and responsibilities of both are much the same.

Under the laws of substantially all jurisdictions a corporation, whether it be organized as a cooperative or for profit, when it comes into being has a board of directors named in its articles of incorporation, but it has no other officers, there being a marked distinction between the office of director and that of executives or other administrative officers. Directors, acting collectively as a Board, in truth and in fact are the corporation, while its other officers are but employees and agents. The office of director is usually created by law. The other offices are as determined by the directors, stockholders, or members, dependent upon the bylaws of the corporation.

While in the absence of any restrictive provisions any person would be qualified for election as a director of a corporation, membership on the board of directors of a Farmers' Cooperative Association is usually limited to agricultural producers or their representatives, just as is membership in the cooperative. Sometimes, however, provision is made for a representative of the public to sit with the board of directors by reason of the fact that the orderly marketing of farm products is a matter of vital concern to the general public. Even though one occupying the office of director may not be qualified to serve as such, still while so acting he is regarded as a de facto director. While his right to serve may be challenged through appropriate legal action by the stockholders or members, still all corporate activities in which he participates are just as effective from a corporate standpoint as if he were a duly qualified director.

Election alone does not qualify one as a director of a corporation, a necessary incident being the acceptance of office, which may be express or implied through acquiescence in acting as a director. The term of office of a director is usually fixed by law, the articles of incorporation, or bylaws. Usually provision is made for an annual election of directors, either for the board as a whole or for a designated portion if the term of directors is to be staggered.

The function and powers of the corporation are to be exercised by the directors in meeting assembled. It is only when so acting as a board that the directors can bind the corporation. The stockholders or members have a right to expect concerted action and the expressed

judgment of the directors. Directors, acting individually outside of a meeting, cannot bind the corporation even though more than a majority of the entire board may concur in the determination.

If there be specific provision in the statute, the articles of incorporation, or bylaws respecting the place of meeting, the board must meet at the designated place; otherwise the meeting may be held anywhere. If notice of meeting be required, the meeting is ineffectual for any purpose unless notice be served on each of the directors or unless it be waived or all the directors be present at the meeting. Once a legal meeting has been convened, the meeting may be adjourned and the same business transacted at the adjourned meeting as could have been transacted at the original meeting, the presumption being, in the absence of anything to the contrary, that the meeting was legally convened.

Although vested with the corporate powers and the conduct and control of the corporation, the right of directors to act for the corporation is at all times subject to such express restriction and limitations as may be imposed in the statute, the articles of incorporation, or the bylaws. Thus, while the board of directors has power to bind the corporation to any contract within its express or implied powers, without reference to the stockholders or members, still it has no authority to make or authorize contracts beyond the powers conferred. The attempt to do so would be an ultra vires act. While an ultra vires contract might be enforced against the corporation if entered into with a third party, still the attempt to enter into such contracts may be enjoined at the suit of a stockholder or member, and a director responsible therefor may be held personally liable. Where broad powers are granted to the directors, then the question as to how far the board of directors should go in the exercise of its powers is a matter of policy for the directors to decide. It is the plain duty of the directors to conserve the property and assets of the corporation and promote its welfare according to their best judgment, regardless of personal interest.

No useful purpose would be here served by delineating that which is required of a board of directors in the discharge of their duties and their control and management of the corporation. I take it that others who are participating in this program will have something to say in that regard.

Directors, while not trustees in the ordinary sense of the word, nevertheless occupy a fiduciary relationship to the corporation and as such are held strictly accountable for their acts, and it is well to bear in mind the fact that one who acts as a fiduciary is held to strict accountability in the discharge of his duties, the following being suggested as of importance in our consideration of the "Legal Responsibilities of a Cooperative Director."

A director cannot blindly close his eyes and thus escape his responsibilities. A director not only has the right, but it is his duty to become thoroughly conversant with the corporate business including, among other things, its financial status and requirements.

A director is under an obligation to disclose such knowledge as he may have affecting the business, operations, and welfare of the corporation.

A director cannot use the corporate property or his relationship to it for his own personal gain, nor can he make a profit at the expense of the corporation. Any profit arising in the conduct of the corporate business or management of its property belongs to the corporation, and if it comes to the director, he takes it as a trustee for the corporation.

A director cannot acquire an adverse interest in property or profit by claims acquired against the corporation or make a secret profit in any transaction affecting the corporation.

A director may not engage in a rival business detrimental to the corporation which he serves as a fiduciary, although in the absence of an express prohibition he may not be debarred as a matter of law from engaging in the same and a competing business so long as he acts in perfect good faith with his associates. Obviously, however, such a relationship would be extremely difficult to sustain.

Directors are required to administer and manage the affairs of the corporation for the common benefit of all and must exercise their best care, skill, and judgment in the management of the corporation solely in its interest and to promote the general welfare and not in the interest of any particular group. They must not manipulate the corporate affairs so as to give control to one group or exclude another.

A director has no right to sell his influence or enter into agreements which would control his official acts even though he may, of course, preliminary to an election, make a declaration of policy, on the basis of which he may be elected to office. Action contrary to the rule herein set forth would be an abuse of the confidential relationship to be discharged by the directors.

As in the case of other fiduciaries, a director who has a personal interest in a corporate contract or undertaking is disqualified from voting for its adoption, and any such contract or undertaking in which he has an interest is either void or voidable, at the option of the corporation, unless authorized or ratified by a disinterested quorum of the board of directors.

Directors are not empowered to give away the property or assets of the corporation. As to what constitutes a "gift" within the meaning of his prohibition sometimes raises a most interesting problem, as, for example, a contribution to the Community Chest or other charitable institution, or the grant of money to an officer with whom no express or implied arrangement was made in advance for the payment of compensation. In passing, it may be stated that the restrictive rule as here expressed is liberally construed when no abuse of discretion is evidenced and the action was taken in good faith.

Responsibility for the determination of the overhead policies rests with the board of directors, but they are not, and should not be concerned with details of operations, responsibility for which rests in the executive or administrative officers of the corporation. This, however, does not mean that the directors are relieved from responsibility for all operational details. On the contrary there may be a particular situation for which they are charged with responsibility, as for example, the permissive retention of an officer or employee known to be incompetent or dishonest. Prior to a recent amendment of our Constitution, the directors of a corporation were personally liable to the stockholders and members for such amount as might be embezzled by an employee, regardless as to whether or not they had knowledge of any dishonesty on his part or any reason that he was not a trustworthy employee.

A breach of the fiduciary obligations imposed on directors subjects them to liability enforceable through legal proceedings instituted by the corporation, its stockholders, or members. Where liability exists on the part of the directors for wrongful acts, it is usually joint and several, and a director forced to make restitution usually would have no recourse for contribution from his fellow directors, despite the fact that they were equally culpable, there being no right of contribution as between wrongdoers.

One who has accepted the office of director should not hesitate to express his opinion in a board meeting concerning any corporate policy or proposed course of action. If he has reason to believe that the contemplated action is unauthorized or wrongful, then he should so express himself and require his dissent to be noted in the minutes, for only by so doing can he clear the record and avoid being liable to the corporation, its stockholders, and members, for the unauthorized or wrongful act.

While the foregoing may serve as a brief outline of some of the legal responsibilities of directors, be they directors of a cooperative or of a corporation operated for profit, still it must be confessed that there has been much left unsaid. Throughout, it must be noted that there runs one cardinal rule - directors and particularly directors of cooperatives, in the discharge of their duties of office must use good common sense, take an active interest in the business of the association, exercise the utmost good faith in all their dealings, seek no personal advantage, and give their utmost endeavors to promote the welfare of the association as a whole, regardless of group or personal interest.

Sheffield Farms Company, Inc., Ordered to Stop Controlling Cooperative Association Producers

On November 26, 1941, the Federal Trade Commission issued a complaint against Sheffield Farms Company, Inc. [Docket No. 4647], charging in brief that that company had violated the Federal Trade Commission Act through organizing and perpetuating a cooperative association of producers which it was alleged was controlled by the company. The Federal Trade Commission averred that this constituted an unfair method of competition and gave Sheffield Farms Company, Inc., an unfair competitive advantage. Paragraphs 3 and 6 of the complaint of the Federal Trade Commission read respectively as follows:

"PARAGRAPH THREE: The production and distribution of milk is a primary industry affecting, in a large measure, the health and welfare of the general public. Milk usually is not distributed to the consuming public by the milk producers. These milk producers make their livelihood through the sale of their milk to distributors and dealers therein such as the respondent. Various investigations and studies have been made to ascertain the best method whereby the producers could sell their milk and secure the highest possible return; it has been determined that this result could be accomplished most effectively through producer cooperative associations controlled exclusively by the dairy farmer members thereof. It is the policy of the Government of the United States, and also of many States, including the State of New York, to foster and encourage the formation and functioning of such producer-controlled and producer-owned cooperatives and to permit such cooperatives to also join together for their mutual benefit."

"PARAGRAPH SIX: Prior to about 1922, respondent had bargained with and purchased a substantial part of the milk which it distributed from producer-controlled and producer-owned cooperatives. During the year 1922, in order to prevent the producers from whom respondent purchased milk from joining, or retaining their membership in such cooperatives, respondent organized all of said producers into the 'Sheffield Farms Company Producers Association,' hereinafter referred to as the 'Association.' The organization of the Association was initiated, sponsored and controlled entirely by representatives and agents of respondent. At the organization meeting of the Association, which was held in the offices of respondent, where practically all of the meetings of the board of directors of the Association have been held ever since, the delegates of the producers were handed a constitution and by-laws which had been prepared by the respondent. Membership in the Association was definitely restricted to those producers who delivered milk to one of respondent's country receiving plants."

On February 27, 1948, a "Cease and Desist" order was issued to Sheffield Farms Company, Inc., as follows:

"UNITED STATES OF AMERICA
BEFORE FEDERAL TRADE COMMISSION

At a regular session of the Federal Trade Commission, held at its office in the city of Washington, D. C., on the 27th day of February, A.D., 1948.

COMMISSIONERS:

Robert E. Freer, Chairman,
Garland S. Ferguson,
Ewin L. Davis,
William A. Ayres,
Lowell B. Mason.

In the Matter of SHEFFIELD FARMS COMPANY, INC. — DOCKET NO. 4647 — ORDER TO CEASE AND DESIST

"This proceeding having been heard by the Federal Trade Commission upon the complaint of the Commission, the answer of the respondent, testimony and other evidence taken before a trial examiner of the Commission theretofore duly designated by it (all intervening procedure having been waived by stipulation of counsel and the Commission having approved and accepted said stipulation); and the Commission having made its findings as to the facts and its conclusion that the respondent has violated the provisions of the Federal Trade Commission Act:

"IT IS ORDERED that respondent, Sheffield Farms Company, Inc., its successors or assigns, officers, representatives, agents and employees, in connection with the purchase, receipt, sale, or distribution of milk, in any amount and in any form, in commerce, between and among the various and several States of the United States and in the District of Columbia, do forthwith cease and desist from directly or indirectly:

"1. Organizing or creating, or attempting to organize or create, by any means or method whatsoever, any association or group of milk producers, the purpose of the association or group being to sell the milk produced by its members to the respondent, in any form or in any amount;

"2. Controlling or attempting to control, by any means or method whatsoever, the admission to, or retention of, membership by any milk producer in any association or group of milk producers, the purpose of the association or group being to sell the milk produced by its members to the respondent, in any form or in any amount;

"3. Controlling, dominating, or attempting to control or dominate by any manner or method whatsoever, the management or operation of any association or group of milk producers, the purpose of the association or group being to sell the milk produced by its members to the respondent, in any form or in any amount;

"4. Controlling, attempting to control, by any manner or by any method whatsoever, or campaigning in relation to, or in connection with, the selection or election of any officials, representatives, delegates, directors, officers, or agents by the members of any association or group of milk producers, the purpose of the association or group being to sell the milk produced by its members to the respondent, in any form or in any amount;

"5. Dominating, controlling, or attempting to dominate or control, by any means, manner, or method whatsoever, any association or group of milk producers, the purpose of the association or group being to sell the milk produced by its members to the respondent, in any form or in any amount, for the purpose, or with the effect, of causing such association or group, or the officials thereof, to act solely in the interest of, or for the benefit of, the respondent and to the detriment of the association or group.

"IT IS FURTHER ORDERED that the respondent shall, within sixty (60) days after service upon it of this order, file with the Commission a report in writing, setting forth in detail the manner and form in which it has complied with this order.

"By the Commission.

SEAL

Otis B. Johnson,
Secretary."

There follows a ruling of the General Counsel of the Bureau of Internal Revenue given a number of years ago which holds that on the sale of assets by an organization it was unnecessary to take depreciation on the assets during the period that it was an exempt organization:

"SECTION 111. - DETERMINATION OF AMOUNT OF GAIN OR LOSS

ARTICLE 651: Determination of the amount of gain or loss — XI-37-5676, G.C.M. 10857

REVENUE ACT OF 1928

"Where an organization derived taxable gain from the sale of its property, the basis should not be reduced by the amount of depreciation sustained with respect to the property for the period during which the taxpayer occupied the status of an exempt organization.

"The question is presented whether a taxpayer which derived taxable gain from the sale of its assets in 1931 should, in computing the gain derived from the sale, reduce the basis on account of depreciation sustained for the period during which the taxpayer occupied the status of an exempt organization.

"It appears from the internal revenue agent's report that the taxpayer acquired the property in question prior to March 1, 1913, and that the March 1, 1913, value of the property was the basis to be used in computing the gain derived from the sale of the property. Accordingly, it is not necessary to consider depreciation sustained prior to March 1, 1913. In computing the gain the internal revenue agent did not reduce the basis on account of depreciation, upon the theory that no depreciation was allowable with respect to the property, since the taxpayer was an exempt organization under the Revenue Act of 1928 and all prior Revenue Acts.

"Under sections 111 (a) and (b) and 113 (b) of the Revenue Act of 1928, the basis of the property in this case is the March 1, 1913, value thereof, diminished by the amount of deductions for exhaustion, wear and tear, obsolescence, amortization, and depletion which have since the acquisition of the property been allowable in respect of such property under the Revenue Act of 1928 and prior Revenue Acts. It is obvious that for the period during which the taxpayer occupied the status of an exempt organization no deduction with respect to the property on account of depreciation was allowable for income tax purposes. Consequently, there was no return of capital to the taxpayer in the form of depreciation allowances.

"Examination of the various Revenue Acts, beginning with the Revenue Act of 1913, shows that each Act has provided for a deduction for depreciation with respect to property used in trade or business. In the instant case the file discloses that the taxpayer occupied the status of an exempt organization under all those Revenue Acts. It is, accordingly, the opinion of this office that for the purpose of computing gain or loss from the sale thereof the basis of the property in question should not be diminished by the amount of depreciation sustained with respect to the property since March 1, 1913."

It is understood that the foregoing ruling has not been revoked.

In the case of Pomeroy v. Westaway, 70 N.Y.S. 2d 449, the court, in referring to the bylaws of A. D. Julliard & Company, Inc. said:

> "Article 36 of the by-laws of the company, entitled, 'Transfers of Stock', so far as here pertinent, provides: '* * * No transfer of stock shall be made on the books of the company, and no sale or assignment thereof shall be valid, unless such stock shall have first been offered to the corporation, and second to the stockholders of this corporation, if the corporation shall fail, neglect or refuse to purchase the same, subject to the condition that the corporation might acquire any part of said offering before any of said stock should be offered to the stockholders.'"

Stock in the company was transferred without complying with the conditions of the bylaw, and one of the stockholders of the company brought suit to have the transfer set aside. The defendants claimed that the bylaw had been abrogated by nonobservance. In holding for the defendants, the court said:

> "The rule is recognized that stockholders may by consent or by acts and conduct repeal or accomplish the modification or abrogation of a by-law, as fully and effectively as if done by them by formal action, and the by-law is deemed to have been repealed or modified, as the case may be; likewise, non-usage of a by-law, continuing for a considerable length of time, and acquiesced therein, will work its abrogation. Evans v. Southern Tier Masonic Relief Ass'n, 76 App. Div. 151, 78 N.Y.S. 611; Bowler v. America Box Strap Co., 22 Misc. 335, 49 N.Y.S. 153; Bay City Lumber Co. v. Anderson, 8 Wash. 2d 191; 111 P. 2d 771; Elliott v. Lindquist, 94 Pittsburgh Leg.Jr.Pa., 295; 14 C.J., § 456, page 359; 18 C.J.S., Corporations, § 188; 1 Cook, Corporations, ed. 8, § 4a, p. 37; 8 Fletcher, Cyc. Corporations, § 4183, p. 693; 1 Morawetz, Private Corporations, ed. 2, § 499, p. 468; 2 Thompson, Corporations, Ed. 3, §§ 1158, 1159, pp. 577, 580; 1 White, New York Corporations, ed. 1927, p. 175."

The Supreme Court of Pennsylvania in the case of Elliott v. Lindquist, 356 Pa. 385, 52 A. 2d 180, reached a similar conclusion regarding bylaws that were identical in purpose with those discussed above. In doing so, the court said:

> "The learned court was of the opinion that the by-laws 'constitute the contract between the stockholders and are subject to the rules governing a written contract signed by all the parties. It follows that contracting parties cannot ignore their own contractual covenants with impunity and still seek to hold the others to the contract,' citing Constructor's Association of Western Pennsylvania v. Seeds, 142 Pa. Super. 59, 61, 15 A.2d 467, in support of that conclusion. Parties to a written contract may abandon, modify or

change it by words or by conduct. Weldon & Kelly Co. v. Pavia Co., 354 Pa. 75, 79, 46 A.2d 466; Jacobs v. School District of Wilkes Barre Twp., 355 Pa. 449, 453, 50 A.2d 354. By-laws consistent with constitution and statute are really the private statutes of the company enacted by the stockholders for the regulation of its affairs. Compare Bagley v. Reno Oil Co., 201 Pa. 78, 50 A. 760, 56 L.R.A. 184. Generally, a man may waive the benefit of a statute. Compare In re Redstone Tp. School Dist. in Fayette County, 284 Pa. 325, 331 et seq., 131 A. 226. No case has been called to our attention in which we have passed on the effect of long continued disregard of by-laws by the only parties who could be interested in the enforcement of their provisions. In other States the point has been ruled in accord with defendants' contention: see Huxtable v. Berg, 98 Wash. 616, 623, 168 P. 187; Bay City Lumber Co. v. Anderson, 8 Wash. 2d 191, 204, 111 P. 2d 771; Farmer's State Bank of Riverton v. Haun, 30 Wyo. 322, 345, 222 P. 45; Salvail v. Catholic Order of Foresters, 70 N.H. 635, 50 A. 100; Buck v. Troy Aqueduct Co., 76 Vt. 75, 56 A. 285; Mutual Building & Loan Ass'n of Eufaula v. Guice, 27 Ala. App. 7, 165 So. 864; Bowler v. America Box Strap Co., 22 Misc. 335, 49 N.Y.S. 153; Sovereign Camp W.O.W. v. Sabalza, Tex. Civ. App., 93 S.W. 2d 177; Modern Woodmen of America v. Harper, 127 Tex. 489, 94 S.W. 2d 156, 157; Mathews v. Fort Valley Cotton Mills, 177 Ga. 340, 176 S.E. 505; National Aid Life Ass'n v. Kerr, 180 Okl. 59, 67 P. 2d 935; Grand Valley Irrigation Co. v. Fruita Improvement Co., 37 Colo. 483, 508, 86 P. 324, 332. In this last case the reason for the rule was stated: 'The authorities which we cited clearly sustain the proposition that, since this provision of the by-laws was for the benefit and protection of the stockholders themselves, they might waive it, and such by-law, as to them, would be repealed by their acquiescence in the uniform practice of the company in disregarding it.'

"Appellants, in contending that the by-laws cannot be suspended or abrogated by non-usage, refer to section 5 of the by-laws providing that they may 'be altered, amended, modified or added to by the vote of stockholders holding a majority of the stock of the company, present in person or by proxy, at any general or special meeting (called for that purpose) of stockholders of the company. A copy of such amended by-laws shall be sent to each stockholder within 30 days after their adoption.' We do not think that section was intended to exclude the right of all the stockholders to waive provisions of the by-laws made for their benefit." (Underscoring added.)